THE FINANCIAL SERVICES ROUNDTABLE

Testimony of

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on behalf of

The Financial Services Roundtable

Before the

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Financial Services Subcommittee
on Financial Institutions and Consumer Credit
on

Legislation To Allow the Payment of Interest on Corporate Checking Accounts and Interest on Sterile Reserves

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My name is Thomas P. Jennings and I am the General Counsel of First Virginia Banks, Inc. in Falls Church, Virginia. I am pleased to have the opportunity today to speak on behalf of The Financial Services Roundtable. First Virginia is the oldest bank holding company in Virginia, with roots beginning in 1949. Although we are now a multi-state organization with banking companies in Virginia, Maryland, and Tennessee and nonbanking offices throughout the mid-Atlantic and Southeastern states, we are strongly committed to our super community banking organization structure and to maintaining independent local banks. We utilize independent boards of directors and locally based management.

The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to American consumers. Member companies participate through their Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for the engine of our nation's economy, accounting directly for $17 trillion in managed assets, $6.6 trillion in assets, and $462 billion in revenue, and providing jobs for 1.6 million employees.

Chairman Bachus, thank you for holding this hearing today and for inviting the Roundtable to participate. The Roundtable also extends thanks to Congresswoman Sue Kelly (R-NY) for introducing the "Small Business Interest Checking Act of 2001," which will be the focus of my testimony. This bill would help remove the "hidden tax" imposed on banks by allowing the payment of interest on banks' required reserves.

The Roundtable strongly believes that any bill that allows institutions to pay interest on commercial checking accounts, such as the "Business Checking Freedom Act of 2001" introduced by Congressman Pat Toomey (R-PA), must be coupled with provisions allowing the Federal Reserve Board to pay interest on required reserves. The reason for this is simple. If institutions are to begin paying interest on commercial checking accounts, they will be forced to undertake significant changes to operating systems, and more importantly, they will be pressured to revisit their pricing for numerous account relationships. As explained by Federal Reserve Governor Laurence Meyer in testimony given in 1999 to the Subcommittee on Financial Institutions, "[f]or banks, interest on demand deposits will increase costs...[these costs] will be partially offset by interest on reserve balances."

Non-interest bearing or "sterile" reserves held at the Federal Reserve amount to a hidden tax on banks. This non-productive use of deposits runs counter to the interests of all of our key constituencies, including our bank's management, shareholders, and most importantly, our customers and communities. Reserve requirements make banks less likely to develop new and innovative deposit products since the costs of these products are artificially high. In addition, reserve requirements limit banks' participation in markets, such as for short-term repurchase agreements, since reserve requirements impose artificial costs on such activities.

Let me explain how the bill to permit the payment of interest on business checking will affect First Virginia. Currently, our family of banks meets all of its reserve requirements though "vault cash" the money we keep in branches and other service facilities – and through required balances held at the Federal Reserve. First Virginia has a program in place to aggressively manage the cash we hold – and where we hold it – in order to ensure that our customers receive cash when they need it. Because banks our size must hold ten cents in reserves for every additional dollar held in checking accounts, allowing the payment of interest on business checking accounts would increase amounts held in these accounts, thus substantially increasing our reserve requirements. The corresponding increase in required reserves may force us to hold excess cash over and above the amount that we need to meet our customer needs. If First Virginia were to carry this money without receiving interest on it or without being able to put it to productive use, it could increase the hidden tax paid by our institution. If the Federal Reserve were to pay First Virginia and other banks interest on the reserves kept with them, the costs of holding these excess reserves would be at least partially offset.

I also would like to point out a possible unintended consequence if a policy change results in banks holding additional non-interest bearing reserves. Because an increase in such reserves would make it more expensive for banks to offer checking accounts, many consumers might choose to place their money in accounts outside of the banking system. The end result might be that the Federal Reserve would hold even fewer reserves, because banks would be holding fewer deposits.

In the past, Congress has linked the issue of paying interest on required reserves with paying interest on commercial checking. In 1998, the House Banking Committee included both provisions as part of a broader regulatory relief package. That bill, H.R. 4364, the "Depository Institution Regulatory Streamlining Act of 1998," passed the House by voice vote.

As the Committee has already heard, strong monetary policy arguments exist for allowing the Federal Reserve to pay interest on required reserves. While I will not go into details on the monetary policy-related issues, I will point out that Federal Reserve officials have frequently supported positive Congressional action in this area. Perhaps most convincingly, Alan Greenspan has argued:

> (I)t would be helpful to prevent a further increase in the volatility of the effective federal funds rate that might result from a further sweep-induced decline in required reserves. And a means is available to the Congress today to accomplish that end: **The Federal Reserve should be permitted to pay interest on reserves.** As it stands now, depositories resort to complicated means to evade our reserve requirements -- such as retail sweeps -- because our reserves are sterile and to do less would put them at a competitive disadvantage in a market where profit margins are paper thin. By paying interest on reserves, the incentive to engage in sweeps would be sharply reduced and the practice would likely diminish over time, if not end entirely. As a result, bankers could devote their attention to more productive

pursuits, and reserve markets would be easier to read” (emphasis added).

Additionally, in 1997, the Federal Reserve Board published a paper by two staff economists that concluded that “reductions in reserve balances increase the volatility of the federal funds rate...” Further, the model developed by these two economists suggested that d reserves could increase funds-rate volatility significantly.”

Mr. Chairman, in conclusion, the Roundtable appreciates the opportunity to provide our comments on this important legislation that would remove the hidden tax on banks and urges Congress to follow its historical practice of combining payment of interest on reserves legislation with interest on commercial checking legislation. Thank you again for this opportunity and I would be pleased to try to answer any questions that Members of the Subcommittee might have on this issue.